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Banking Antitrust in Transition

Since 1979, there has been an unusually strong merger movement in the United States banking industry. Banking mergers have grown dramatically not only in number, but also in size (see chart). The causes of this wave of mergers are a matter of debate, but most observers agree that a desire for geographic expansion and for self-protective growth in anticipation of interstate banking have been important.

Many of these mergers have involved large banks of regional and national significance, but, unlike the 1960s and 1970s, federal authorities have rejected very few on the basis of antitrust concerns. As a result, many analysts have concluded that banking antitrust standards are more lenient now than at any time in the past. Some observers have even suggested that antitrust concerns are essentially a "dead" issue in today's banking mergers.

What has happened, then, in the 1980s to cause this apparent turnabout in the application of antitrust standards? This *Letter* identifies a number of developments that have contributed to the greater leniency in current banking antitrust.

Background

Unlike other U.S. industries, banking in general has been subject to antitrust review for only a few decades. Prior to the passage of the Bank Merger Act of 1960, banking was widely held to be separate from "commerce" and therefore not subject to antitrust laws. The Supreme Court's 1963 decision involving the Philadelphia National Bank, however, removed any doubts as to the applicability of antitrust to banking.

In this landmark case, the Court found commercial banks to offer a unique "cluster" of products that comprised a separate line of commerce subject to the antitrust standards of Section 7 of the Clayton Act (1914). This important antitrust law prohibits mergers when "in any line of commerce in any section of the country the effect of such acquisition may be to substantially lessen competition." The Supreme Court reaffirmed its stance in the Philadelphia National case in later cases involving the Phillipsburg National Bank (1970) and the Connecticut National Bank (1974).

Since the 1960s, the task of reviewing the antitrust effects of proposed commercial bank mergers and bank holding company (BHC) acquisitions has rested primarily with the three federal banking agencies. Jurisdiction over mergers is determined by the charter class and Federal Reserve System membership status of the surviving bank. The Federal Deposit Insurance Corporation (FDIC) has jurisdiction over state nonmember banks, the Federal Reserve System over state member banks and all acquisitions involving bank holding companies, and the Comptroller of the Currency over national banks. The Department of Justice (DOJ) also plays a role in banking antitrust in that it may, within 30 days of agency approval, bring suit to prevent any merger.

Antitrust analysis

Since the Supreme Court's decision in the Philadelphia National case, the three banking agencies have taken a more or less uniform analytical approach to assessing bank mergers. Of primary importance in that approach is the theory that banking market structure influences market conduct which, in turn, influences market performance. It has generally been assumed that markets with more banking firms and less deposit concentration will exhibit greater competition and lower profits. (This structure-conduct-performance hypothesis is not accepted by all economists although numerous empirical investigations in both the industrial and banking sectors tend to support it.)

Assessing the antitrust effects of a bank merger, therefore, entails judging the likely impact of a proposed merger on the structure of the market in which the merging banks are located. To do this requires the delineation of a relevant geographic market and the identification of all commercial banking competitors. So-called "horizontal mergers" occur between banks in the same geographic market and eliminate "existing competition." "Market extension" mergers are those that occur between banks located in separate geographic markets; such mergers may eliminate "potential" or "probable future" competition.

The competitive importance of a bank is generally estimated by its share of market deposits. Thus, horizontal mergers alter market structure and increase a merging bank's market power by combining the bank's deposits with those of a competitor. Similarly, substantial market power can be obtained quickly by a banking firm that wishes to enter a new market and does so via a market extension merger with a leading competitor in the new market. From an antitrust viewpoint, either type of merger may, at times, be undesirable if the banking markets involved are noncompetitive.

What has changed?

Prior to this decade, it was common for the banking agencies to reject proposed bank mergers and BHC acquisitions for antitrust reasons. Since 1980, legislative changes, judicial rulings, and agency decisions have combined to create a regulatory climate that has produced far fewer rejections of both horizontal and market extension mergers.

On the legislative side, it is difficult to understate the importance of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982. These two laws substantially increased the "banking" powers (asset and liability) of thrift institutions and further weakened the much-attacked concept of commercial banking as a separate line of commerce. As a result, the banking agencies and the DOJ have recognized thrift institutions as at least partial competitors of commercial banks. Including thrifts in the competitive framework tends to lead to a new view of market structure as being more atomistic and less concentrated than in the past. Within this new view, horizontal bank mergers now tend to cause fewer objectionable changes in competition.

The inclusion of thrifts as banking competitors has also made it less likely that regulators would reject market extension mergers under existing antitrust laws. Prior to 1980, market extension bank mergers and BHC acquisitions were disapproved with some regularity. A 1981 ruling by the U.S. Fifth Circuit Court of Appeals, however, changed this by overturning the Federal Reserve's 1980 rejection of two market extension acquisitions in Texas. (In another important 1981 decision, this Court also ruled that no banking acquisition or merger could be denied for competitive reasons unless the merger or acquisition constituted an antitrust violation. Thus, the antitrust standards of the banking agencies cannot be more strict than those of the DOJ.)

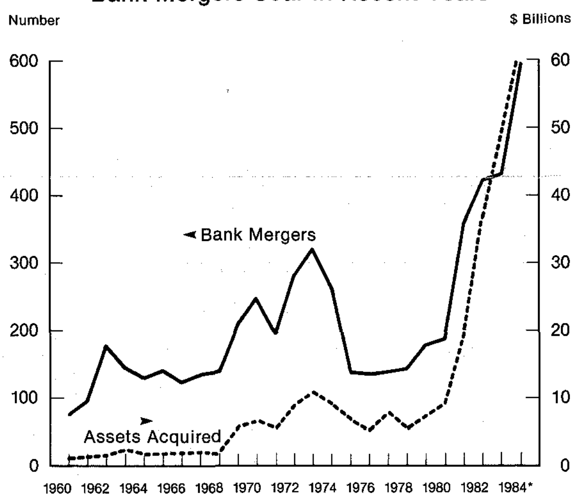
Although careful not to invalidate the theory of potential and probable future competition, the Court delineated four specific criteria that would have to be met before a market extension merger could be rejected on antitrust grounds: (1) the target market is operating noncompetitively (i.e., it is highly concentrated), (2) the acquiring firm is a likely entrant (either foothold or *de novo*) into the target market, (3) there are few likely potential entrants, and (4) alternative entry by the acquiring firm would significantly encourage competition in the market structure.

Experience since this ruling has demonstrated that most banking markets are reasonably competitive — that is, not highly concentrated — when thrifts are included as banking competitors. This is especially true of states such as California and Florida where thrifts are prevalent. Also, because of the branching powers that thrifts generally enjoy there are almost always more than a "few" potential entrants into any banking market. The number of potential entrants into many banking markets has also increased dramatically because of recent changes in interstate banking laws that now permit entry into local markets by out-of-state firms.

The combined impact of the 1980 and 1982 legislation and the 1981 Fifth Circuit Court ruling on market extension mergers has been significant. No banking agency has denied a market extension merger since 1980.

Agency rulings in merger cases since 1980 have also contributed to more lenient antitrust standards. One such ruling by the Comptroller of the Currency (OCC) in 1984 further expanded the universe of firms that the OCC considers to be competitors to banks. The ruling was made in connection with the approval of a horizontal

Bank Mergers Soar in Recent Years



* 1984 Figures Are Preliminary

merger of two Pennsylvania banks and gave competitive weight not only to thrifts but also to certain nonbanking firms such as finance companies and brokerage firms — some of which had no physical presence in the relevant geographic market.

Similarly, in 1985 the FDIC adopted new explicit merger guidelines that support the notion of a disaggregated (multiproduct) line of commerce in banking. As a result, future bank mergers decided by the OCC and the FDIC are virtually certain to assign a competitive role for firms traditionally believed to be noncompetitive with banks.

A development unrelated to the line of commerce issue but one that has greatly facilitated bank mergers in the 1980s has been the use of branch and deposit divestitures to eliminate or reduce the negative antitrust effects of certain horizontal mergers. In contrast to the industrial sector, where selective divestitures in mergers have been acceptable for many years, bank regulators have discouraged the use of selective divestitures in bank mergers prior to this decade. Now, proposed mergers between large banking firms that operated in one or more common markets can almost always meet agency standards governing the elimination of existing competition through such divestitures. The banking agencies currently also allow firms to "fine tune" their merger proposals by reducing or eliminating altogether the amount of deposits and assets to be acquired in markets where existing competition is an important issue.

Finally, some observers believe that the Department of Justice also has promoted a climate of leniency toward bank mergers during the 1980s. In addition to indicating (in 1980) that it intended to be more receptive to mergers in general, the DOJ has twice (in 1982 and 1984) revised its horizontal merger guidelines in ways that most observers agree allow more mergers. The DOJ's infrequent legal challenges to bank mergers in recent years has underlined the view that the DOJ has become more receptive to bank mergers.

Conclusion

The current merger movement in banking is being abetted by antitrust practices and standards that have become significantly more lenient during the 1980s. The current antitrust climate in banking is largely the result of the changing nature of banking and recent legislative, judicial, and agency rulings. One important consequence of these developments has been a retreat from the traditional concept of commercial banking as a separate line of commerce and a leaning toward a view of banking as a multiproduct activity in which numerous types of financial services firms engage. Because of these developments, it appears that existing antitrust laws and standards will not be important constraints on the industry consolidation that is expected to occur as the result of extensive interstate banking.

Anthony W. Cyrnak

Research Department
Federal Reserve
Bank of
San Francisco

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/3/86	Change from 11/26/86	Change from 12/4/85 Dollar	
Loans, Leases and Investments[1] [2]	204,087	324	4,662	2.3
Loans and Leases[1] [6]	183,827	480	3,060	1.6
Commercial and Industrial	51,044	966	– 1,025	– 1.9
Real estate	67,134	166	1,238	1.8
Loans to Individuals	39,677	– 48	1,598	4.1
Leases	5,593	16	169	3.1
U.S. Treasury and Agency Securities[2]	12,679	24	1,405	12.4
Other Securities[2]	7,582	– 178	198	2.6
Total Deposits	210,264	1,654	6,238	3.0
Demand Deposits	57,550	1,039	6,069	11.7
Demand Deposits Adjusted[3]	39,900	2,663	6,112	18.0
Other Transaction Balances[4]	18,951	723	3,846	25.4
Total Non-Transaction Balances[6]	133,762	– 110	– 3,678	– 2.6
Money Market Deposit Accounts—Total	46,561	158	783	1.7
Time Deposits in Amounts of $100,000 or more	32,053	– 302	– 5,943	– 15.6
Other Liabilities for Borrowed Money[5]	27,162	799	– 626	– 2.2

Two Week Averages of Daily Figures	Period ended 12/1/86	Period ended 11/17/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	93	66
Borrowings	23	63
Net free reserves (+)/Net borrowed(–)	70	3

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change